AN INQUIRY INTO 'THE NATURE OF CAPITAL' WITH SPECIAL REFERENCE TO C.I.R versus MIDDELMAN

by

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I dedicate this modest work to my wife, Nuala Siubán, in gratitude for so many years of love and support.

CONTENTS

CHAPTER ONE

INTRODUCTION

Our Courts have, in many decisions stretching over decades, been faced with the problem of deciding whether the proceeds of the disposal of certain assets are revenue, or are of a capital nature. The assets which have given rise to the problem are those which one would normally consider to be capital in the hands of the taxpayer, but which may be held to have to have altered in character due to some action of the taxpayer, either by way of a change in the intention of the taxpayer regarding the asset in question, or by virtue of the method adopted by him in the disposal of the asset. The reported cases dealing with this question arise mainly from the disposal of either shares or immovable property, although this has not always been the case. The principles involved in the inquiry remain the same, no matter what the nature of the asset is, but the application of those principles depends on a number of factors, including the nature of the asset, and of course, the circumstances of the taxpayer.

Every taxpayer, whether he be an individual, or a Company, has circumstances which are peculiar to himself. In the same way every capital asset, whether it be held in the form of shares or in land has particular circumstances which will influence the method of development and realisation. Accordingly, a Court, in deciding whether the proceeds of disposal of a particular asset by a particular taxpayer, is or is not subject to income tax, has to consider the totality of all the circumstances involved. For this reason it may sometimes appear on a first reading that contradictory decisions have been arrived at, whereas in fact the decisions can be explained by differences, sometimes subtle, in the facts of the cases concerned.

Accordingly, the tax advisor must be careful not to allow pre-conceived ideas to cloud his judgement when considering a matter before him. It may well be that, hidden in the thicket of facts which seem to be common to all such matters, lies the single flower which will distinguish one matter from all others.

Such a case was that of Mr Hans Middelman, whose share dealing activities were recently considered by a Full Bench of the Cape Provincial Division in the matter of Commissioner for Inland Revenue vs Middelman, a case which is, as yet, unreported.

Mr Middelman was a director of companies who had acquired a portfolio of shares for investment purposes. He bought and sold shares with some regularity, and during the three year period under review by the Court he conducted 32 sales and incurred losses on only 4 occasions. The profits which he made on the sales of shares exceeded the dividend income from all shares owned by him. He acknowledged that he was an expert in share investments and maintained a policy of actively managing his portfolio. Before purchasing a share he made certain assumptions about its future prospects; If these assumptions were not realised the share was sold and the proceeds used to purchase other shares. He had also sold shares in order to raise cash for other purposes.

On these summarised facts, which will be dealt with later in greater detail, the Receiver of Revenue concluded that the taxpayer had embarked upon the trade of sharedealing, and sought to tax the proceeds. On the face of it, and in the light of a number of decisions which will also be considered, it would seem that there was considerable justification for the attitude taken up by the Commissioner. However, Mr Middelman won his case in the Special Income Tax Court, and won again when taken on appeal to the Full Bench.

The immediate question that arises is whether this decision indicates that an individual, managing his capital in the manner referred to has greater scope to avoid the tax net than had been thought, or whether there were circumstances peculiar to Mr Middelman which would make his case unique. In order to consider this question, one has to return to first principles, gleamed from a long time of cases, and apply these to this case, and of course to every matter which the practioner may be called upon to consider. At the same time, some of the broader issues involved in matters of this nature will be examined.

CHAPTER TWO

THE INITIAL INQUIRY

The Judicial Definitions of "Capital" and "Revenue"

The fact that one is investigating a share dealing transaction makes no difference to the principles involved in deciding whether the proceeds of a particular transaction are capital or revenue. The basic inquiry holds good for every type of transaction, and must begin with the definition of "Gross Income" in Section 1 of the Income Tax Act (1). This refers to "the total amount ... received by/or accrued to ... such person ... excluding receipts or accruals of a capital nature."

The Income Tax Act makes no attempt to define the concept "... of a capital nature ..." This task has been left to the courts to decide in each particular matter; the difficulties and limitations inherent in attempting such a definition, no doubt being the reason for the omission.

The Courts have commented on what capital is and what income is but they have not attempted to give an all embracing definition of the phrase "of a capital nature" which could be used in all cases where the question to be determined is whether any particular receipt or accrual is, or is not, "of a capital nature". *(Sub Nigel vs C.I.R.)* (2). The impossibility of defining such a vague concept being self evident.

Nevertheless in dealing with the question whether in particular circumstances a receipt or accrual is, or is not, of a capital nature, the Courts have over the years, decided in a long line of cases, what factors may be legitimately taken into account in determining the question. The principles thus established afford a measure of guidance where the question has to be determined in any particular case. *(John Bell and Company (Pty) Limited vs S.I.R.)* (3). However, as in all revenue cases the dictum of Steyn C.J. in *C.I.R. vs African Oxygen Limited (4)* must always be borne in mind:- "In so far as cases in our Courts decide what factors are to be taken into account in dealing with such a question, or cases in other Courts applying similar provisions draw attention to features which may on good grounds be accepted as relevant, they are of course of assistance, <u>but each case must be decided on its own facts and circumstances</u>."(Emphasis supplied).

Before dealing with the manner in which the courts have endeavoured to distinguish between capital and revenue it will be instructive to see how the courts regard those concepts.

In *Commissioner of Taxes vs Booysens Estate Limited* (5) Innes C J said:- "Income considered in relation to capital is revenue derived from capital productivity employed. In a transaction of this nature where profit has resulted from the disposal of the company's assets we have to enquire whether profit has resulted from the productive use of capital employed to earn it, or whether it has resulted from the realisation of capital at an enhanced value".

In *C.I.R. vs Visser* (6) the Court said:- "If we take the economic meaning of 'capital' and 'income', the one excludes the other. 'Income' is what 'capital' produces, or is something in the nature of interest or fruit as opposed to principal or tree. This economic distinction is a useful guide in matters of income tax, but its application is very often a matter of great difficulty, for what is principal, or tree in the hands of one man, may be interest or fruit in the hands of another".

In *Overseas trust Corporation vs C.I.R. (7)* Innes C J was again seized of the problem:- "Where an asset was realised at a profit as a mere change of investment there was no difference in character between the amount of the enhancement and the balance of the proceeds. But where the profit was a gain made by an operation of business in carrying out a scheme for profit making, then it was revenue derived from capital productively employed, and must be income".

In similar fashion, Stratford C J said in *Lace Proprietary Mines Limited vs C.I.R. (8)*:- "Is the accrual the result of the productive use of capital employed to earn profits? If so, it is income within the meaning of the Act for it is not an accrual of a capital nature".

The Appellate Division made an attempt to give a definitive meaning to "fixed capital" in *S.B.I. vs Aveling* (9). The Court said that the essence of it was "... 'n element van permanentheid in die sin dat daar 'n bedoeling is om die betrokke bate min of meer permanent te hou met die doel dat dit inkomste moet voortbring". Those words may well have been appropriate to the facts of that particular case, but they very obviously cannot form a general definition of a capital asset. Not all capital goods actually produce income for the taxpayer. His residence, for example is clearly a capital asset, as a piece of vacant, unused land may be, although neither are income producing. In *Bloch vs C.I.R.* (10), Vos J realising the shortcomings of the definition in Aveling's case attempted to expand on it. He preferred, he said, to say that capital is that which is held with an element of permanency and with the object that it should produce an economic utility for the holder.

This statement of Vos J, is the closest that the Courts have come to the all-embracing "touchstone" referred to in the Sub-Nigel case, and while not solving the problems inherent in the inquiry is a most useful guideline.

<u>Onus and Method of Approach</u>

The onus to prove that the receipts in question are of a capital nature lies, in terms of Section 82 of the Income Tax Act, on the taxpayer, and is to be discharged, as in all civil matters, on a balance of probabilities. To discharge this onus the taxpayer has to show that the asset in question was, and remained, an item of fixed capital in his hands. How he goes about satisfying the Court in this regard can be gleaned from some of the judgements in which the subject has been considered.

Holmes J.A. laid down the method of approach in his introductory remarks in *Natal Estates Limited vs S.I.R. (11).* "In deciding whether a case is one of realising a capital asset or of carrying on a business, or embarking upon a scheme of selling land for profit, one must think ones way through all the particular facts of each case. Important considerations include, inter alia, the intention of the owner, both at the time of buying and of selling, the objects of the owner, if a company; his activities up to the time of selling, the light such activities throw on his ipse dixit, ... and the relationship of all this to the ordinary commercial concept of carrying on a business or embarking on a scheme for profit".

Miller J adopted much the same approach in *I.T.C. 1185 (12).* "Perhaps the most important test in considering whether it is the one or the other of these (i.e. capital or revenue) is the intention with which or the object for which the property is acquired. But it is clear that the application of that test will not in all cases produce the true answer to the fundamental question; a taxpayer might have bought property with the intention of holding it as a investment of capital for the purpose of earning income, but have changed his mind at a later stage and resolved to merge that asset with his ordinary stock in trade as it were".

Wessels J.A. dealt with the matter in *C.I.R. vs Stott (13)* as follows:- "For the purpose of ascertaining whether profits made upon the sale of an article are taxable, I think it accurate to say that it depends upon whether the article was acquired for the purpose of trade or not. It is unnecessary to go so far as to say that the intention is conclusive as to whether the proceeds are taxable. It is sufficient to say that the intention is an important factor, and <u>unless some other factor intervenes</u> to show that when the article was sold it was sold in pursuance of a scheme of profit making, it is conclusive in determining whether it is capital or gross income". (Emphasis supplied).

Clearly then, the starting point in the inquiry is to ascertain what the taxpayer's intention was when the asset was acquired. It then moves on to ascertain whether he may have had a second intention, whether his intention changed or can be deemed to have changed. Intention however is not the only criterion. There are other factors such as the scale of the taxpayers operation, the problems faced by Companies, and the commercial consequences of the taxpayers actions. One can do no better than adopt the sage advice of Holmes J.A. in the Natal Estates case (11) "to think ones way through all the facts of each case".

<u>The Difference between Land and Share Transactions</u>

The basic principles involved in attempting to differentiate between capital and revenue apply whatever the nature of the asset involved may be. In the application of those principles however, there are some differences between share dealing, and land transactions. The latter usually involves either township development, or the conversion of a property to Sectional Title and the sale of units. Generally share dealing cases involve the management and maintenance of a portfolio of shares. The essential difference between the two is usually that erven, or Sectional Title units are created from an asset which was acquired as capital, and then disposed of. In the case of shares, a portfolio is built up and then individual shares within that portfolio are bought and sold in the course of managing the portfolio. Of course, were a taxpayer to purchase and sell erven, that would be similar to share dealing.

In the case of land transactions involving development and sale, it is trite law that a taxpayer is entitled to dispose of his capital asset to best advantage, and the mere fact that he does so in stages, or in a manner which involves him in development, does not, by itself, alter the capital nature of the asset.

In share dealing cases, the portfolio as a whole may well be retained with the object of long term capital investment, while individual components are bought and sold. The question whether the taxpayer has gone over to trading in either case depends largely on scale. In the case of shares, this is complicated by the fact that prevailing economic conditions may have a marked effect. If the stock market is dropping, an investor may well be justified in selling shares to preserve the value of his portfolio. If the market is rising, then it may well be held that profits on sales were forseeable and that the taxpayer had therefor embarked on a scheme for profit making.

Some of these problems will be considered again, but it is necessary to bear them in mind when applying cases involving one type of transaction to facts in the other type.

CHAPTER TWO

(1) Income Tax Act No. 58 of 1962 as amended.

(2) Sub-Nigel Limited versus Commissioner for Inland Revenue 1948 (4) S.A. 580 A.D. at page 595.

(3) John Bell and Company (Pty) Limited versus Secretary for Inland Revenue 1976 (4) S.A. 415 A.D. at page 426 H.

(4) Commissioner for Inland Revenue versus African Oxygen Limited 1963 (1) S.A. 681 A.D. at page 691 A.

(5) Commissioner of Taxes versus Booysens Estate Limited 1918 A.D. 576 at page 595.

(6) Commissioner for Inland Revenue versus Visser 1937 T.P.D. 77.

(7) Overseas Trust Corporation Limited versus Commissioner for Inland Revenue 1926 A.D. 444 at page 453.

(8) Lace Proprietary Mines Limited versus Commissioner for Inland Revenue 1938 A.D. 267 at page 277.

(9) Sekretaris van Binnelandse Inkomste versus Aveling 1978(1) S.A. 862 A.D. at page 880.

(10) Bloch versus Secretary for Inland Revenue 1980 (2) S.A. 401 C.P.D. at page 411.

(11) Natal Estates Limited versus Secretary for Inland Revenue 1975 (4) S.A. 177 A.D. at page 202.

(12) Income Tax Case 1185, 1974 S.A. Tax Cases Volume 35 page 122.

(13) Commissioner for Inland Revenue versus Stott 1928 A.D. 252 at page 264.

CHAPTER THREE

THE CONCEPT OF INTENTION

What is meant, in the legal sense, by the concept of intention? This was considered by Lord Hailsham in *Director of Public Prosecutions vs Hyam* (1). He said that purpose, (or motive) is what is in a persons mind when he performs an act. "Intention", which has a wider meaning embraces, in addition to the objective, all necessary consequences of an action, including the means to the end, and any consequences intended along with the end. "Intention", the learned Judge went on to say, includes "sub-conscious motives". It follows therefor that intention is to be sought in a much wider field than the taxpayers ipse dixit; the logical consequences of his actions must be investigated. The question of how the taxpayers intention is to be ascertained will be dealt with in greater detail when examining the ipse dixit, but for the present only the consequences of intention, once ascertained, will be looked at.

The Original Intention

The importance of ascertaining the taxpayers intention when acquiring the asset in question has been referred to in a quotation from Wessels J A in Stotts case (2). If the taxpayer's intention was to acquire the asset to hold as an investment, or to paraphrase the words of Vos J in Bloch's case, (3) to hold the asset with an element of permanancy with the object of obtaining an economic benefit from it, then that asset becomes capital in the hands of the investor. It remains capital unless and until some other factor intervenes to change the character of the asset.

In examining the taxpayers original intention it has been held that it is not necessary that he should have excluded from his mind the slightest contemplation of a profitable resale of the asset, in order to establish a capital intention. *(C of T vs Levy) (4).* This would indeed be an unnatural standard to apply.

Of course, if the taxpayer uses the asset in a scheme of profit making, then the intention and means of acquisition will not be relevant. In *C.I.R. vs Strathmore Exploration Limited (5)* the Company acquired property by inheritance. Its objects empowered it to do "landjobbing", and that is what it set about. The profits were held to be taxable.

Having ascertained the taxpayers intention in acquiring the asset, one must then consider whether he may not have had, or be deemed to have had, a second objective in mind. The taxpayer may well have purchased shares with the intention of holding for dividends, but may also have had in mind the idea of selling at a profit if the right circumstances arose. If neither objective is dominant then the problem which the taxpayer faces in Court is that he is unable to discharge the onus imposed on him under Section 82 of the Income Tax Act. He will be involved in the single business of turning his asset to account and the proceeds of either course will be taxable *(Durban*

North Traders vs C.I.R.) (6).

If it can be held that a taxpayer had a dual intention in his dealings then, in the first instance the Court must seek out a dominant intention, and if one exists, apply it to the case. In *C.O.T. vs Levy (4)* the following statement was made "...where the purposes of an individual taxpayer are mixed, the only course on principle as well as for practical reasons, is to seek and give effect to the dominant factor operating to induce him to effect the purchase. It seems to me that the only test to apply is that of the main or dominant purpose". (7) In *S.I.R. vs African Life Investment Corporation (Pty) Limited (8)* Steyn C J assumed that the criterion was also applicable to a company. (9) His comments on the principle involved will be referred to again. (10) In applying this to the facts of the case, the Chief Justice said:- "Where for instance a company, whose main concern as an investor is an income from dividends, confines its purchases to sound equities with the highest dividend yield, but, at the same time intends, in order to increase its income, to sell whenever it is able to do so at a substantial profit, that intention, although so closely connected with its main object that it may be said to be inseparable from it, would not ordinarily rank as merely incidental to such a dominant purpose ... whatever the primary objects of a company might be, it is quite possible that it may derive income in the ordinary course of business from carrying out its secondary objects".(11)

In this case it was held that the taxpayer knew in advance that variations in investments would be profitable, and also that variations were an integral part of the management of its portfolio. It thus had in mind a definite purpose, distinguishable from, but not unconnected with its purpose of acquiring dividends. Under those circumstances, the regular dealing in shares could not be held to be a merely incidental activity.

The principle was applied in the *Barnato Holdings Limited vs S.I.R* (12) in a somewhat different manner. Here it was held that the taxpayer acquired shares with the intention, inter alia, that, should their market price increase without a corresponding increase in yield it was a business policy to sell them, generally at a profit. This amounted to a clear, secondary intention.

The same principle was considered in *C.I.R. vs Tod* (13) in relation to what was described in the judgement as phase three of Tods operation. He bought and sold shares with some regularity in order to acquire the dividends on the shares. Although it was accepted that the main purpose was the acquisition of dividends, the fact that it was contemplated and even planned that frequent purchases and sales would be carried out, and that sales would not be made at a loss, amounted to a secondary intention to earn profits. The profit that resulted from these frequent sales therefor "was no fortuitous enhancement. It followed from facts which were within the contemplating of the contracting parties and the resulting benefits must have been within their intention. The profits of such a transaction are not of the nature of capital". (Overseas Trust Corporation vs C.I.R. (14)).

The line between the secondary intention which becomes a business, and the management of a portfolio must necessarily be a fine one. It must be an integral part of the proper management of a portfolio of shares which are held "for keeps" that from time to time particular shares within that portfolio will deteriorate in value, and it cannot be expected of a prudent investor that he must refrain from intervening for fear of being taxed on any profits made while switching from shares whose value is declining to better shares. The problem that this gives rise to is where the line should be drawn. The African Life case and that of Barnato Holdings, and Tod referred to above, show clearly that while income may be the main object of the investor, this can well be present at the same time as a decision that the taxpayer is trading in shares.

However, if one of the taxpayers intentions is dominant then that dominant purpose prevails. Support for this principle is to be found in Levys case (4) and S.I.R. vs African Life Investment Corporation (8).

The meaning of "dominant intention" was considered in *C of T vs Glass (15)*, decided in the Federal Court of Rhodesia and Nyasaland. The relevant paragraph from the judgement reads as follows:- "A dominant purpose exists where the alternative objective, through perhaps in contemplation, and even a material factor in the general decision to buy, was entirely secondary and did not operate to a substantial extent on the taxpayers mind. If his real motives were so mixed that he may be fairly said to have been substantially and almost equally moved by both, the fact that he preferred one potential result to the other, would not amount to a dominant purpose".

The question was also dealt with, albeit from a different point of view in *African Life Investment Corporation (Pty) Limited vs S.I.R. (8)*. In this case Steyn C J considered what a dominant purpose was. "Whether or not a purpose is dominant in the sense that another co-existing purpose may be effected at a profit without attracting liability for tax is a matter of degree, depending on the circumstances. A purpose may be a main purpose without being dominant... there would I consider be such a main purpose, where tl.ere is a further purpose, simultaneously pursued by way of an additional, albeit subsidiary, activity calculated to yield a profit" (16). In other words a main purpose under such circumstances would not absolve the profits of the secondary activity from tax.

In *C.I.R. vs Paul (17)* the taxpayer wished to purchase 30 to 40 acres of a certain piece of land. The owner however, was only willing to sell a much larger portion, which the taxpayer purchased. Later he sold off the surplus at a profit, retaining the ground he originally wanted. The Commissioner alleged that he had made a business of selling off the surplus, but the Court held that his dominant purpose was the acquisition of that portion of the land he wanted and that he was merely engaged in disposing of a capital asset to best advantage.

A Change of Intention

The inquiry must then proceed to investigate whether the taxpayer, either while holding the asset, or in deciding to dispose of it, may have changed the intention he had on acquisition. There are two aspects to this part of the inquiry. The taxpayer may have subjectively and deliberately changed his intention. More likely, and more difficult to ascertain, the change of intention may be deemed to have taken place from the circumstances surrounding the decision to dispose of the asset, or the circumstances under which the asset was disposed of.

Here again, a change of intention does not necessarily render the proceeds of a sale taxable. In a minority judgement in *C.I.R. vs Richmond Estates (Pty) Limited (18),* Schreiner J A discussed this problem. He stated that while the cases have held that a change of intention may effect the results they have not found that a change of policy or intention by itself, necessarily effects a change in the character of the assets in question.

In the Natal Estates case (19) the company embarked upon township development of land which, until then, was clearly a capital asset. The development took place on a large scale, and Holmes J.A. said "...with its elaborate and sustained scheme and expertise (the Appellant) was doing much more than merely realising a capital asset to the best advantage in a businesslike manner; by any canons of commerce it had gone beyond that field; it had crossed the Rubicon and committed itself on a grand scale to the course and business of selling land for profit, using its land as its stock-in-trade" (20).

Natal Estates Limited were taxed on the profits of their disposal on account of the scale of the operation upon which they embarked, this scale amounting to a change of intention. The question of scale will be referred to again.

In *Barnato Holdings Limited vs S.I.R* (12) the taxpayer lost as it was held that it had embarked upon a secondary business. This case will be considered in some detail later. This is a similar principle to that referred to above in the Natal Estates case (19). The court in Barnato Holdings Limited accepted that the taxpayers primary business (i.e. intention) was and remained the holding of long term investments. However, it was held that it had become an integral, albeit secondary part of their business to deal in shares. Accordingly while each transaction which the Company had entered into considered in isolation, might per se be regarded as merely a change in the holding of an investment, when the totality of all the numerous transactions (the circumstances, nature, extent and frequency) was regarded they must be accepted as falling within a secondary business. The Court went on to find that in acquiring the shares Barnato Holdings Limited had the intention, inter alia, that, should the price rise without a corresponding increase in yield, it was a business policy to sell them.

Some Other Considerations

In the Natal Estates Limited case (19) the Appellate Division considered the scale upon which the development and disposal of the land was conducted. Natal Estates Limited had owned most of the property involved for decades and had farmed on it. There is no doubt that it was a capital asset in the hands of the Company prior to the decision to sell. This decision had been forced on the Company. The land in question was required by the City of Durban for urban development and the Company had been advised that if it did not itself develop the land this would be expropriated. It was argued on behalf of the Company that under those circumstances what it was doing was disposing of its capital asset to best advantage and that the character of the enhancement was not changed by the disposal. The Company denied that there had been any change of intention which would have the effect of altering the nature of the land from capital to stock. The finding of the Court was that by virtue of the scale on which the development was carried out the taxpayer had made a business of its disposal. In effect, the grand scale of the operation amounted to a deemed change of intention.

One of the fundamental pillars of this judgement was that, by virtue of the grand scale of the disposal operation the taxpayer had " crossed the Rubicon" and had to be deemed to have embarked upon an operation of business in carrying out a scheme for profit making. The Court spoke of " the test of degree..." and went on "... where the owner sub-divides the land, the planning, extent, duration, nature, degree, organisation and marketing operation of the enterprise and the relation of all this to the commercial concept of carrying on a business... from the totality of the facts, one enquires whether it can be said that the owner has crossed the Rubicon and gone over to business"(21). Although the scale of operations was not the prime reason for the finding in either Barnato Holdings Limited (12) nor in African Life Investment Corporation Limited (8), nevertheless the scale was investigated and commented on in both cases, and became a relevant part of the inquiry into the principles which decided them. it is difficult to believe that, had Barnato Holdings Limited only been involved in, say, a quarter of the number of transactions mentioned in the judgement, the Court would have come to the same conclusion. The facts in Income Tax case No. 1354 (22) were somewhat similar to those in Barnato Holdings Limited, but here the transactions were in fact conducted on a lesser scale. This was commented on by the Court and the case was decided, inter alia, on the grounds that the scale of operation did not approach that of Barnato Holdings Limited.

The test of scale can be traced back to the principle first set out by Lord Justice Clerk in California Copper Syndicate vs Harris (I.R.) (23) as follows:- "... the question to be determined being - Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making"?

In *Overseas Trust Corporation Limited vs C.I.R. (14)* Innes C J adopted that phrase and went on to expand its scope - "This (the profit in the case) was no fortuitous and unforeseen enhancement. It followed from facts which were within the knowledge of the contracting parties, and the resulting benefits must have been within their contemplation and intention. The profits of such a transaction are not of the nature of capital"(23).

The words "scheme for profit making" and "foreseen enhancement" really mean that the profits in question are designedly sought and worked for (24).

In the Overseas Trust case (14) the taxpayer did not sell an asset at a profit. It acquired shares in the knowledge that the holder of such shares would become entitled to an ascertainable sum of money in due course, which was in excess of the purchase price of the shares. The ratio of the decision was the foreseeability of the resultant enhancement.

In seeking to ascertain the taxpayers intention towards his asset as part of the inquiry as to whether the asset is capital, the Courts have, in two cases, dealt with what we may term the "for keeps" principle. In the Barnato Holdings Limited case (12), the Company conceded that shares were subject to fluctuations in value, and that accordingly it was necessary from time to time to switch out of some shares and into others, and this was always contemplated as part of its business. Trollip J.A. in dealing with this aspect, wrote:- "This would tend to indicate prima facie that those shares were not acquired for better or worse, or relatively speaking, for "keeps", (i.e. only to be disposed of if some unusual, unexpected or special circumstance warranting or inducing disposal, supervened), which is the usual badge of a fixed, capital investment" (24).

In *Commissioner for Inland Revenue vs Tod* (13), the Court looked at the circumstances in which the taxpayer acquired his portfolio of shares and how he had rationalised it by selling certain shares and buying others. Having done so, Milne J P concluded:- "I think it is fair to sum up the evidence thus far by saying that there is no reason whatsoever to doubt that, although the taxpayer spread the risk in his portfolio by shedding some shares, reducing his holding in others, and acquiring still others, one is looking at a portfolio of shares that was held for long term investment purposes" (25). The Judge then quoted with approval the extract from the judgement of Trollip J A set out above, and applied it to Tods case.

In Barnato Holdings Limited (12) the Court applied the "for keeps" principle to the individual shares in the portfolio, while in Tods case (13) the Court applied it to the portfolio as a whole. This apparant discrepancy can be explained firstly by the vastly greater scale on which Barnato Holdings operated, and secondly, by the fact that the Court found that Barnato Holdings had embarked on a secondary business of sharedealing. Tod fell into neither of these categories.

CHAPTER THREE

(1) Director of Public Prosecutions versus Hyam 1974 (2) ALL E.R. at page 41.

(2) Commissioner for Inland Revenue versus Stott 1928 A.D. 252 at page 264.

(3) Bloch versus Secretary for Inland Revenue 1980 (2) S.A. 401 C.P.D.

(4) Commissioner of Taxes versus Levy 1952 (2) S.A. A.D. 413.

(5) Commissioner for Inland Revenue versus Strathmore Exploration Limited 1956(1) S.A. 591 A.D.

(6) Durban North Traders versus Commissioner for Inland Revenue 1956 (4) S.A. 594 A.D.

(7) See footnote (4) at page 421 A.

(8) African Life Investment Corporation (Pty) Limited versus Secretary for Inland Revenue 1969 (4) S.A. 259 A.D.

(9) See footnote (8) at 269 D.

(10) See Chapter Three, page 21.

(11) See footnote (8) at 269 F to G.

(12) Barnato Holdings Limited versus Secretary for Inland Revenue 1978 (2) S.A. 440 A.D.

(13) Commissioner for Inland Revenue vs Tod 1983 (2) S.A. 364 N.P.D.

(14) Overseas Trust Corporation Limited versus Commissioner for Inland Revenue 1926 A.D. 444.

(15) Commissioner of Taxes versus Glass 1962 (1) S.A. 872 F.C. at page 884 A.

(16) See footnote (8) at page 269 E.

(17) Commissioner for Inland Revenue versus Paul 1956 S.A. 335 A.D.

(18) Commissioner for Inland Revenue versus Richmond Estates (Pty) Limited 1956 (1) S.A. 602 A.D.

(19) Natal Estates Limited versus Secretary for Inland Revenue 1975 (4) S.A. 177 A.D.

(20) See footnote (19) at page 204 G.

(21) See footnote (19) at page 202 H.

(22) Income Tax case 1354. S.A. Tax cases Volume 44 page 18.

(23) See footnote (14) at page 453.

(24) Meyerowitz and Spiro "On Income Tax" paragraph 299.

(25) See footnote (13) at page 372 A.

CHAPTER FOUR

THE TAXPAYERS IPSE DIXIT

Counsel for Middelman (1) submitted that, while the taxpayers ipse dixit is not necessarily conclusive, when the Court has no reason to disbelieve his evidence, and it is not contradicted by the objective facts, then the taxpayer will have discharged the onus upon him. The Court held that there could be no quarrel with that statement. "The Taxpayer" (2) writes that this is an important finding which can be relied upon by others in appropriate circumstances.

In an earlier edition of "The Taxpayer" (3) the task of the Court in ascertaining intention is aptly summed up. "Tax Law has attempted to ascertain the taxpayers intention ... by considering not only his ipse dixit but a range of factual criteria such as the conduct of the taxpayer in relation to the transactions in issue, the frequency of involvement in transactions of a similar kind, the nature of his business organisation etc. From these objective facts, our Courts have sought to imply an intention to the taxpayer".

If consideration and weight is given to the meaning of "intention" as set out by Lord Hailsham in Hyams case (4), then clearly the taxpayers ipse dixit cannot be considered in isolation.

In *I.T.C. 1185, (5),* Miller J, when dealing with the ipse dixit on intention said "It is the function of the Court to determine on an objective review of all the relevant facts and circumstances, what the motive, purpose and intention of the taxpayer were. Not the least important of the facts will be the course of conduct of the taxpayer in relation to the transactions in issue, the nature of his business or occupation and the frequency or otherwise of his past involvement or participation in similar transactions. The facts in regard to those matters will form an important part of the material from which the Court will draw its own inferences against the background of the general human and business probabilities. This is not to say that the Court will give little or no weight to what the taxpayer says his intention was. ... The taxpayer's evidence under oath ... must necessarily be given full consideration, but direct evidence must be weighed and tested against the probabilities and the inferences normally to be drawn from the established facts".

This passage was adopted in the C.P.D. by Grosskopf J, in *Malan vs K.B.I. (6).* He went on to say, "Die rede waarom 'n belastingpligtige se ipse dixit nie noordwendig aanvaar word nie, hoef nie te beteken dat sy eerlikheid in twyfel getrek word nie. Mense se bedoelings is dikwels wisselend, ongevorm en ongeformuleer, en hul ex post facto getuienis daaroor, hoewel eerlik, is dikwels onbetroubaar, of bestaan uit blote rekonstruksie".

When the same case went to the Appeal Court *(7)* Rabie C J, considered that Grosskopf J had gone too far. He said that, because of the onus which is imposed on the taxpayer by Section 82 of the Income Tax Act, his evidence and credibility must be very carefully considered. He went on, "'n bevinding van geloofwaardigheid kan, afhangende van die feite van die saak, 'n faktor van deurslaggewende belang wees."

The statement of Berman J, in Middelman (1) referred to in the first paragraph of this chapter is in line with, and supported by that of Rabie C J. The problem, however, lies in the qualification which each attaches to his judgement. A finding of credibility in favour of the taxpayer is decisive in discharging the onus, provided that his evidence is not contradicted by the objective facts (per Berman J) or "afhangende van die feite van die saak". (Per Rabie C J) These qualifications leave the test to the discretion and opinion of the Judge in each case. He still has to consider the objective facts, and it is submitted that the test formulated by Miller J, is still applicable. Otherwise the statement of Berman J makes little sense. He said "... when the Court has no reason to disbelieve his evidence, AND it is not contradicted by the objective facts" (Emphasis supplied). Unless the objective facts are regarded in the manner suggested by Miller J then it would be a contradiction to give credibility to the taxpayer and yet find that his ipse dixit was drawn into question by other facts.

There appears thus to be little doubt that the ipse dixit cannot be, and is not, considered in isolation. A finding of credibility in favour of the taxpayer is not enough. It is but one factor, albeit an important factor, in a range of issues which must be considered by the Court, particularly in ascertaining intention. One is once again reminded of the words of Holmes J.A (8) that the tax advisor is required to "think ones way through all the particular facts of each case".

CHAPTER FOUR

(1) Commissioner for Inland Revenue versus Middelman 1989 C.P.D. not reported, but published in "The Taxpayer" February 1990 from page 32.

(2) "The Taxpayer" February 1990 at page 34.

(3) "The Taxpayer" May 1988 at page 82.

(4) Director of Public Prosecutions versus Hyam 1974 (2) ALL E.R at page 41 quoted in Chapter Three hereof, page 1C.

(5) Income Tax case 1185, 1974 S.A. Tax cases Volume 35 page 122.

(6) Malan versus Kommisaris van Binnelandse Inkomste 1981 (2) S.A. 91 K.P.A. at page 96 F.

(7) Malan versus Kommisaris van Binnelandse Inkomste 1983 (3) S.A. I.A.D. at page 18 E.

(8) In Natal Estates Limited versus Secretary for Inland Revenue 1975 (4) S.A. 177 A.D. at 202 H.

CHAPTER FIVE

COMPANIES AND INDIVIDUALS

That the Courts do look with different eyes at Companies and Individuals has been clear both in South Africa and in Britain for a very long time. The question first arose in the English case of *Smith vs Anderson (1).* The Master of the Rolls said in that case that acts done by a company may be regarded as business, while those same acts, if done by an individual would not. He went on"- "A man occasionally buys and sells land, as many landowners do, and nobody would say that he was a landjobber or dealer in land, but if a man made it his particular business to buy and sell land to obtain profit, he would be designated as a dealer in land".

The principle has been explained and expanded upon in a number of English decisions. It was considered in some detail in *Inland Revenue vs Korean Syndicate Limited (2).* The purpose for which the Company was formed, was described in its Memorandum, inter alia, as that of acquiring mining concessions and turning them to account for the purpose of making a profit. It obtained such a concession in Korea, which it originally proposed to work with its own capital. However, it then entered into an agreement to hand over its rights to another company and receive an annual payment. The nature of this contract was in dispute, and the Company argued that, were it an individual, the annual payments would clearly be capital. In rejecting this argument the Court said "The fact that a limited company and an individual come into existence in a different way is a matter to be considered. An individual comes into existence for many purposes, or perhaps for none, whereas a limited company comes into existence for some particular purpose". If the company carries out that purpose then it is trading, the Court held.

The question came before the same Court in *Inland Revenue Commissioners vs Westleigh Estates Company Limited (3)*:-"It was contended that the Company was merely in the position of an ordinary landowner dealing with his land, but assuming that in the case of an individual to do such things would not be to carry on a trade or business, it does not at all follow that the conclusion would be the same in the case of a Company, the end and object of whose being is to transact the business in question, and thereby make a profit. The numbers of its transactions are irrelevant if it is formed to carry on a business and it is in fact carrying it on".

The reason for the different approach was explained in *Commissioner of Taxes vs British Australian Wool Realisation Association Limited* (4) as follows:- "The distinction arises from the fact that whereas the capacities of a natural person have no limitation, so that any particular transaction need not be referred to any of them, a company is so bounded by its Memorandum, that it may be both permissible and essential to consider its authorised objects in connection with the actual transaction in question, and even to seek for the principal purpose of its formation".

In *C.I.R. vs Stott* (5) Wessels J A said "If you are dealing with a company, one of whose objects is to buy and sell land, then the company might well be considered to be doing the business of selling and buying land even though it carries out a single transaction".

Accordingly the objects of a company become an important part of the inquiry. The objects were scrutinised in both the Barnato Holdings Limited (6) and African Life (7) cases. On the other hand, Trollop J.A. refused to give too much importance to the objects clauses in *Malone Trust vs S.I.R. (8)*. "It is judicially recognised that objects are often stated in very wide terms in a companies memorandum, merely in case some need to have the corresponding powers may arise at some time in the future. Of greater importance than the cold print of the objects clause are the actualities of the situation". This must be read with a statement of Stratford J A in *C.I.R. vs Lydenberg Platinum Limited (9)* "The test to be applied in the case of an individual is not quite the same as the test in the case of trading company. In the case of a company we have primarily to look at its objects laid down in its constitution and next at its actual operations".

Both judges were dealing with pre-1973 companies. Very few companies today have the all-embracing objects clauses of those companies, but nevertheless the main object and any ancillary objects may well have a bearing on the matter. The deeming provision in Section 33(3) of the Companies Act No. 61 of 1973 may also have to be taken into account.

A company is generally formed for a business purpose and it is reasonable to expect a Court to regard its dealings from that point of view. On the other hand if an individual invests his surplus funds in assets such as shares it is usually clear that his original intention is to invest and to hold his investment. The individual would then have to be seen to be changing over to a position of trading by virtue of the nature or scale of his operations. It is submitted that the finding in Barnato Holdings Limited (6) that the company had engaged in a secondary business is rooted in this principle.

CHAPTER FIVE

(1) Smith versus Anderson (1880) 15 C.H.D. 247.

(2) Inland Revenue versus Korean Syndicate Limited 1921 (3) K.B. 258.

(3) Inland Revenue Commissioners versus Westleigh Estates Company Limited 1924 (1) K.B. 390.

(4) Commissioner of Taxes versus British Australian Wool Realisation Association Limited 1931 A.C. 224.

(5) Commissioner for Inland Revenue versus Stott 1928 A.D. 252 at page 262.

(6) Barnato Holdings Limited versus Secretary for Inland Revenue 1978 (2) S.A. 440 A.D.

(7) African Life Investment Corporation (Pty) Limited versus Secretary for Inland Revenue 1969 (4) S.A. 259 A.D.

(8) Malone Trust versus Secretary for Inland Revenue 1977 (2) S.A. 819 A.D. at 826 B.

(9) Commissioner for Inland Revenue versus Leydenberg Platinum Limited 1929 A.D. 137 at page 145.

CHAPTER SIX

AN EXAMINATION OF THE MIDDELMAN JUDGEMENT

In order that we may consider the Middelman judgement (1) in its proper context it is necessary first to deal with the facts. Unfortunately they were not set out in detail, or in logcal order in the Courts judgement and some reconstruction has been necessary.

Mr Middelman was a director of Companies who had acquired a portfolio of shares for investment purposes. He was an acknowledged expert in share investments, and was a director of at least one public company. He bought and sold shares in the course of managing his portfolio. Unfortunately the judgement does not tell us what the size or value of the portfolio was, but the scale of operations was referred to. During the three year period under review by the Court, Mr Middelman conducted 32 sales, and incurred losses on only 4 occasions. The profits made on the sales were in excess of the dividend received on all shares in the portfolio. As dealings during the period in question took place in a rising market, profits were almost inevitable. There can be no question that he was unaware of this fact, and it must have been within his contemplation while he was conducting his operation.

Mr Middelman's testimony was accepted by the Court without hesitation or qualification. He stated that all purchases of shares were done to maximise long term investment income, and that profit was purely incidental to that aim. He was adamant that he had never bought shares because there was a profit to be made out of their re-sale, nor had he ever sold a share in order to take a profit.

In July 1984 the taxpayer wrote a letter to the Receiver of Revenue setting out what his motivations were when buying shares, and he expanded on this in a subsequent letter a year later. Amongst other things he said that before deciding to purchase a share he made certain assumptions concerning the companies future prospects. If his assumptions were not fulfilled, he then sold the share, regardless of the price, and used the proceeds to purchase other shares. We are not told what the assumptions were, but can assume that these were to the effect that he would continue to receive an adequate return on his investment.

It is implicit in the wording of the letters to the Receiver and in his evidence that Mr Middelman at all times had in mind the possibility that it would be necessary from time to time to sell shares in the portfolio and replace them with shares whose prospects were better. He certainly regarded the portfolio itself as being held "for keeps" for long term investment.

It is true that on occasion he sold shares with a different motive. For instance he sold shares on one occasion in order to raise cash to build a new home. The number of these transactions was not given, but as the Court found that all these " exceptional sales" were adequately explained, and did not amount to a departure from his expressed policy, they need not concern us further.

It is submitted that these facts confirm that in acquiring shares and in building up his portfolio Mr Middelman had a capital intention. The questions that arise therefore are whether this intention was a dominant, or merely a main intention, and whether the scale of the transactions in which he became involved were such that it could be held that he had crossed the Rubicon and gone over to trading.

In seeking the answer to whether the capital intention was a dominant one regard must be had to the words of the Chief Justice in the African Life Investment Corporation case (2). He said that the answer was a matter of degree depending upon the facts. In reaching an answer the Court would have to consider the size of the portfolio, that is the number and value of counters, and balance this against the number of transactions. Also relevant would be the total profit earned from the sale of shares in the period under review.

Unfortunately, the judgement in Middelman's case does not give sufficient detail to enable us to arrive at any conclusions, and so, unfortunately the issue must remain unresolved. One can only comment that this aspect, together with others still to be mentioned, was a matter pertinent to the inquiry before the Court, and if considered in depth could have assisted the Court in resolving the matter.

However, that is not an end to the inquiry. The objective fact remains that the taxpayer had in mind at all times certain factors which also appear to have been glossed over by the Full Bench. These are that criteria were applied to all shares in the portfolio, and that if the shares did not meet the standards set in advance those shares would be sold. This inevitably involved a regular review of the shares held as well as a full study of other shares for potential purchase. The taxpayer was a director of public companies, and a man of admitted expertise in the field in which he operated. To that extent therefor it was not necessary for him to employ advisors as was done in the Barnato Holdings case (3). He dealt over a considerable period in a rising market in which profits were inevitable. The taxpayer must be held to have had a policy to sell shares which failed to maintain the standards which he set for them prior to purchase.

The other side of that coin must surely be that it can never be expected of an investor in shares that he cannot ever review his ownership of a particular share without the shadow of the Receiver of Revenue looming over him. It is inherent in such investment that each share must be reviewed from time to time, and that, in the nature of things, certain shares will deteriorate in value and the prudent investor will replace them with shares of a better quality. It cannot be expected that an investor must stand idly by and watch his capital assets being eroded through factors well beyond his influence. Whether he incurs losses or makes profits on such switching is largely a matter of luck and of history. It is not unlikely that the economy may enter a long downward phase in which overall losses may be expected. Once again the question in each case must be decided upon the scale of the operation. Ordinary reviews, and the sale of non-performing shares is, according to the authorities which have been reviewed herein in order, provided this does not amount to a secondary business. In deciding on scale, one cannot merely regard the numbers of transactions though they must be a relevant factor. The intention behind the sales is of utmost importance.

In the Middelman case Counsel for the Commissioner for Inland Revenue relied heavily in argument on the case of *Barnato Holdings Limited vs S.I.R.* (3). It is accordingly necessary to digress at this stage to examine this case in some detail.

Barnato Holdings Limited was a wholly owned subsidiary of J.C.I. Limited and was used as a vehicle for acquiring and holding industrial shares in the Group. Its Memorandum was investigated in the judgement. The first clause empowered it; "to carry on the business of an investment holding company, and for the sole purpose of investment (i.e. only for the purpose of producing revenue)...

(1) to invest the capital and other money of the company in stocks and shares ...

(2) to vary any investments from time to time and solely for such purpose to turn to account or sell any part of the investment..."

A further paragraph of the Objects clause contained an "independant objects" provision according to which each of the objects or powers were to be regarded as separate and distinct from and independant of each other. The Board of the Company was advised by an investment department consisting of a number of experts who provided detailed analysis of shares. These experts laid down criteria, not only for the purchase of shares, but also which the shares were expected to maintain in the Companies hands. Once shares failed to maintain the standards set, they were sold and the proceeds used to purchase other shares. In a letter to the Receiver of Revenue, written before litigation was contemplated the Company stated that it intended to invest in shares and that its investments would be subject to periodic revision and appropriate re-investment. In a later letter the Company informed the Receiver that its holdings were "constantly reviewed". In the three years under review by the Court, 82 shares were sold, yielding profits of some R3.5million. The value of the portfolio increased in that period from R5 million to R10 million.

The totality of these factors, the Appellate Division found, taking into account the share dealing that actually took place, amounted to the company being engaged in a secondary business of trading. It was an integral part of this decision that the objects of the company empowered it to trade in shares. The power quoted as (2) above, to be read as an independent clause, empowered the company, if it wished, to deal with the shares owned by it at a profit. If the principles dealt with in the Korean Syndicate case (9), and those which followed it, are applied, then it is clear that Barnato Holdings Limited was carrying out an object for which it had been formed, and was accordingly, trading.

In addition, it must be borne in mind that the concept of a secondary business that decided the Barnato Holdings case, is in reality no more than a finding by the Court that its capital intention was not a dominant intention which absolved its other activities from tax. The judgement amounts to a finding that the company had a main intention, as well as a secondary intention, both of which gave rise to taxable profits.

The individual taxpayer, Middelman was not burdened by an objects clause as the company was, nor did he, in the finding of the Court, commit himself to a business policy of selling shares. Berman J., in the Middelman case, distinguished the cases on two grounds, which he said, were fundamental:-

1. Barnato Holdings Limited acknowledged that the switching of share investments was always contemplated as part of its business and with this in view availed itself of a panel of experts. Middelman had no such contemplation in mind and relied on his own expertise.

2. It was a business policy of Barnato Holdings Limited to sell shares whose market value rose without a corresponding increase in dividend yield. There was no suggestion that Middelman ever contemplated such a policy.

Berman J., summed up the differences by saying that it was part of the business of Barnato Holdings Limited to dispose of shares for a variety of reasons; while Middelman's purpose in selling shares was to maintain or increase his dividend income and this was an overriding, main and dominant objective.

In *C.I.R. vs Paul (4)* Centlivres C J commented on the fact that the taxpayer disposed of a capital asset at a profit. Revenue argued that as the Respondent had in mind the object of making a profit on the asset, the profit was thus taxable. At page 341 the Chief Justice said "I think the answer to this contention is simple, it would be contrary to human nature for any person to sell an asset at a loss; when circumstances are such that he decides to sell, he naturally endeavours to get the best price possible". The making of a profit on the disposal of a capital asset does not, per se, bring the transaction into the tax net.

In Tods case (5) at page 373 the court found that the dividend policy was a main object, but could not, on the facts, hold that it was a dominant, overriding object. Accordingly, that object did not solve the taxpayers problem, as there was a secondary objective which gave rise to taxable profits. Apart from this aspect, though, the facts in Tod were different from Middelman in that the taxpayer deliberately embarked upon a policy of buying and selling shares in order to acquire greater dividends.

The court in Middelman did not give any consideration to the principle that emerged from the Overseas Trust case (6). Could it be said, in the light of the fact that the profits made by the taxpayer were made in carrying out a scheme for profit-making, that the profits were fortuitous and unforeseen? These are in reality two separate tests. In the first instance, in view of the Courts findings that the taxpayer did not have a business policy, one would have to accept that a scheme for profit making was not present. A review of a portfolio of shares from time to time and sales made solely as a result of such review, would have to be taken to great lengths in the case of an individual taxpayer, before it could be held to be a scheme for profit making.

The second point presents rather more difficulty. In the Overseas Trust case (6) the taxpayer purchased shares well knowing that ownership thereof would entitle him to receive a sum of money in the future. It was pleaded that the money was a capital enhancement, but because of the prior knowledge, it was held that the sum received was revenue. On this basis it can be argued that, when dealing over a period in a rising market, profits must be foreseen, especially if this is coupled with a policy of, at least, avoiding losses. Certainly this knowledge was an important factor in both the African Life and Barnato cases.

If we can accept, as would appear to follow from what has been said, that Middelman had an original capital intention which did not change; that the scale of his operations did not involve his crossing Holmes J.A's Rubicon (7); that he had not embarked upon a scheme for profit making; and that he intended to hold his portfolio of shares for keeps, then it only remains to decide, on the facts, whether he had a dominant intention in holding his shares for dividends.

In Pauls case (4) the taxpayer sub-divided the surplus land he acquired into a number of smallholdings, and sold off 12 of those properties over a five year period. The scale of that operation was held by the Appellate Division not to be such as would change the dominant intention into what could be described as a main purpose only.

Tods case (5) was divided into a number of phases. In the second phase, the taxpayer decided to spread the risk in his portfolio by selling some shares, reducing his holding in others, and acquiring still others. This process took some two years to complete, and involved a number of sales and purchases and realised a substantial profit. The Court held that the dominant intention remained the retention of the portfolio of shares, for keeps, and that the profits were therefor not subject to tax. Later, Tod embarked on a quite different scheme of buying and selling shares in order to acquire shares "pregnant with dividends" and discard them once the dividend had been secured. This was dealt with on a completely different basis and was held to have been a trading operation.

Stotts case (8) was very similar to Pauls, except that the scale of Stotts operation was greater than that of Paul. Nevertheless, it was held that Stott still maintained the dominant intention of holding his land as an investment.

All these decisions, including that in C.I.R. versus Middelman, confirm that an individual taxpayer has considerable scope in which to build up and manage a portfolio of shares. He will have to establish that the shares were originally purchased with a capital intention and that this intention has not changed at any time. He will have to prove that the portfolio is kept "for keeps" with the object of obtaining dividends. The taxpayer will be free to review and manage the portfolio. Provided that he can prove that the sales which he does make are made only to dispose of shares which do not meet the standard he has set for them, and are made to preserve the value of the portfolio and maximize the dividend income, then any profits made on such sales will be incidental to the dominant intention and not subject to tax. Nevertheless, there remains a line beyond which the taxpayer may not pass. This will bring into operation the other intervening factor of which Wessels J A spoke in the Stott case (8). The taxpayer will have crossed the Rubicon, as Homes J A put it in the Natal Estates case (7). Just where that line is to be drawn is impossible to define. Each case will be decided on its own merits.

CHAPTER SIX

(1) Commissioner for Inland Revenue versus Middelman 1989 C.P.D. Not reported, but published in "The Taxpayer February 1990 from page 32.

(2) African Life Investment Corporation (Pty) Limited versus Secretary for Inland Revenue 1969 (4) S.A. 259 A.D.

(3) Barnato Holdings Limited versus Secretary for Inland Revenue 1978 (2) S.A. 440 A.D.

(4) Commissioner for Inland Revenue versus Paul 1956 (3) S.A. 335 A.D.

(5) Commissioner for Inland Revenue versus Tod 1983 (4) S.A. 364 N.P.D.

(6) Overseas Trust Corporation Limited versus Commissioner for Inland Revenue 1926 A.D. 444.

(7) In Natal Estates Limited versus Secretary for Inland Revenue 1975 (4) S.A. 177 A.D. at 202 H.

(8) Commissioner for Inland Revenue versus Stott 1928 A.D. 252.

(9) Inland Revenue versus Korean Syndicate Limited 1921 (3) K.B. 258.

CHAPTER SEVEN

THE MARGO COMMISSION AND SECTION 9B

It is clear from what has been said that there is a great deal of uncertainty in our Law in distinguishing, in particular cases, between matters which are of a capital nature, and those which constitute income. It was argued before the Margo Commission that this uncertainty had economic consequences for the country in that it prejudiced taxpayers ability to plan their affairs, and it resulted in considerable sums of money being locked in to unproductive capital assets. The argument ran that if there was certainty as to the difference then taxpayers could manage their affairs accordingly.

The Commission considered many of the arguments and the judgments that have been referred to in this paper, and came to the firm conclusion that the subjective criteria that have evolved in the Courts in separating capital gains from income are unsatisfactory (Margo Report, page 221, paragraph 12.24). The Commission found as a fact that funds required for the development of the economy are being immobilised because taxpayers are uncertain whether they will have to pay tax on gains which they may realise in the process of dis-investing from existing investments.

In the course of its consideration of the problem the Commission also considered the advisability of a capital gains tax. For reasons which are outside the scope of this inquiry it recommended that no such tax be introduced, but made the point that, even if it were, this would not, in itself, solve the problem of distinguishing between capital and revenue. In countries which do tax capital gains, the problem remains. That it is not such a visible issue is largely due to the fact that the authorities, knowing that they will collect a tax of some nature, whichever way the decision goes, are more lenient in arriving at such decisions. The problems remain the same.

One suggestion made to the Commission was that all gains made on the Johannesburg Stock Exchange be classified as capital gains. This was rejected as being far too narrow an approach, and for introducing an element of discrimination.

The Commissions solution was to substitute objective criteria as the test in differentiating between capital and revenue, for the subjective tests that have been referred to. Exactly what such criteria should be was not decided, but a number of suggestions were made. Among the tests suggested were: the length of time the asset had been held; the turnover during the year in which the asset was sold, of similar assets owned by the taxpayer; the frequency of transactions; the trade carried on by the taxpayer; and the way in which the proceeds are dealt with in the taxpayers financial statements. The Commission recommended that further research into additional criteria was necessary.

The Commission recognised that the imposition of a rigid test in this manner would, in certain cases, lead to inequities. However, it felt that the certainty that such a test would bring would far outweigh this factor, and that taxpayers would have the opportunity to regulate their affairs in such a way as to avoid most of the injustices that were theoretically possible.

This recommendation by Margo has not, at least not yet, been accepted, apart from the introduction of a new Section 9B to the Income Tax Act. This will be referred to again herein. It is submitted that acceptance of the recommendations would raise as many economic problems as would be solved. One of the major effects, though, of such a test would be to remove the consideration of the question away from the Courts and into the economic sphere.

There was a minority recommendation by two of the Commissioners to the effect that the present system be maintained and that the Commissioners staff be increased in order to deal with applications for rulings in advance of affected transactions. No details were given of the reasoning of the minority but it is submitted that this aspect could be expanded into a workable solution.

Section 3(3) of the Income Tax Act provides that decisions made and notices signed by officers acting under the control or direction of the Commissioner for Inland Revenue may be withdrawn either by the Commissioner, or by the officer concerned, but are effective until so withdrawn. However, such a decision or notice made in the exercise of a discretionary power made under the present or any past Income Tax Act may not be withdrawn after two years have passed from the date of the decision or notice. This applies only to decisions and notices given in writing. Verbal communications are not binding upon the Commissioner. It is also provided that if all relevant facts were not known to the officer concerned at the time the decision was made then it is not binding.

Section 3(3) of the Act provides that if such decision or notice is issued in writing by the Commissioner personally, then he cannot withdraw the decision or notice, provided all relevant facts were known to him.

It has become practise for taxpayers to approach the Revenue in certain instances to ask for a ruling in advance, as to whether a particular transaction which is being contemplated will attract tax or not. A proposed disposal of assets considered by the taxpayer to be capital in his hands, lends itself to such a request for a ruling. Neither the Commissioner nor any of his officers is obliged to give such a ruling in terms of the Income Tax Act as it is presently enacted, but if a ruling is given, then Sections 3(2) and 3 (3) will apply to it.

It is suggested that the Income Tax Act be amended to provide that, in the event of a taxpayer wishing to dispose of an asset which he considers is a capital asset, that taxpayer be entitled, as of right, to obtain a ruling from the Commissioner as to whether the disposal of the asset in the manner suggested by the taxpayer will attract tax. Such ruling, whether issued by the Commissioner or by an official should be made to be binding on the Commissioner and should be issued within a reasonable time of a request being made by the taxpayer.

The legislation should impose an onus on the taxpayer to make a full disclosure of all relevant information, and could provide that the Commissioner have the right to examine the taxpayer under oath on the subject, in the discretion of the Commissioner. In the event of it being shown at a later stage that a full disclosure was not made, then the Commissioner should have the right to set the decision aside. It should also be a provision that a taxpayer dissatisfied with such ruling be entitled to take the matter on appeal to the Special Court for Hearing Income Tax Appeals in the same manner as presently exists in regard to an appeal against an assessment.

A procedure of this nature would, it is submitted, satisfy the objections to the present system based on uncertainty. The taxpayer would not have to place his patrimony at risk in order to discover whether he was liable to tax. The principles which emerge from the cases quoted earlier, which are well grounded in our Law, would not be disturbed, but would rather be re-enforced.

The Legislatures one concession to the Margo Commission lies in the introduction of Section 9B into the Income Tax Act. This provides, that in respect of shares listed on a licensed stock exchange, and which were owned by a taxpayer for a period of ten years, the taxpayer has an election. In the tax year in which such a share is disposed of, the taxpayer may elect to declare the proceeds of such disposal as capital. If he makes this election, then, from that date onwards the proceeds of the sale of all shares which he has held for ten years will be regarded as capital.

The obvious disadvantages are that the section only refers to listed shares that have been owned for a minimum period of ten years, and that the taxpayer, having made the election, is bound thereby, ad infinitum. No losses that he may incur on those shares can be off-set against gains or other revenue. From the nature of share investments many shares will be sold for a variety of reasons within the ten year period, and the Section will thus not apply to them.

It appears that this legislation has been introduced to meet a very specific requirement. Evidence led before the Margo Commission was to the effect that certain investment companies have large shareholdings owned for periods in excess of ten years, but which cannot be disposed of without attracting tax due to other activities by such Companies. This provision will allow them to dispose of these shares.

However, it would not have assisted any of the taxpayers referred to in the reported decisions referred to above, and must have limited application.

TABLE OF CASES